Working Paper
Research Unit EU Integration
Stiftung Wissenschaft und Politik
German Institute for International
and Security Affairs

Ognian Hishow

New Member Economies: Past Versus Future Growth and the Role of the Lisbon Strategy

As of February 2006

Ludwigkirchplatz 3–4
10719 Berlin
Phone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

Working Paper FG 1, 2006/ 10, August 2006
SWP Berlin

New Member Economies: Past Versus Future Growth and the Role of the Lisbon Strategy

Ognian N. Hishow, German Institute for International and Security Affairs (Stiftung Wissenschaft und Politik), Berlin[1]

Key words: growth under economic integration, Lisbon Strategy , real convergence of the new member states; knowledge based growth in CEE, CEE coping with the goals of Lisbon

Will the new entrants ever catch-up?

Modern growth theories, foremost the neoclassical growth theory, predict that low-income economies tend to grow faster because of their higher marginal product of capital. Therefore they eventually should converge on the income level of the more developed nations. But empirical evidence does not support this view, as countless examples from developing countries tell. Yet under given circumstances- especially when nations have similar propensity to save and invest, enjoy equal access to technology, and if they do not differ significantly in their endowment with natural resources- the respective economies may converge in terms of per capita income. Put differently, European countries which integrate politically may sooner or later equalize their standard of living because all other prerequisites are given.

But as the fourth EU extension approached, fears emerged in Germany, France, the Netherlands, and elsewhere in the old EU, that the economy would be adversely affected. The media and politicians continue pointing to the possibility of a significant outflow of jobs to the low-cost eastern part of the EU, while Germany's and France's economy is in a slump and the unemployment rate exceeds 10 percent. Not only do the Poles, Hungarians, Slovaks, and Baltic peoples lure western firms to set up factories in their countries, they also receive subsidies and financial support from West European nations with high taxation, which is deemed unjust.

Such fears appear exaggerated, however, if one bears in mind that capital is always looking for the best investment opportunity. That is why it flows between industries and regions and crosses national borders. The ancient Phoenicians lent money to other Mediterranean colonies, the bank of the Fuggers in the southern German city of Augsburg extended credit to the Austrian Emperor, and in the 19th century Britain became a net lender to the world. Britain, France, Germany, too, benefited by importing foreign capital. After World War II they received financial

[1] For helpful technical support the author wishes to thank Roderick Parkes, M.A.

assistance under the Marshall Plan, which enabled them to restore their severely degraded capital stock quickly. Moreover, as the “poor neighbor” shortly after the war, West Germany boasted low labor costs combined with moderate taxation and a fixed exchange rate of the Deutschmark. Thus, on the one hand, the country benefited from foreign financial support, and, on the other hand, from favorable local conditions for investment. Both boosted the economy in general, and exports in particular, and millions of jobs were created.

The new members are less wealthy relative to the average per capita income of the nations that make up the EU-15, than Portugal, Greece, and Spain were in the mid-eighties. Their GDP per capita in 1986, as the European Community’s extension to the Club-Med was accomplished, was 55.2, 62.9, and 71.8 percent of the average, respectively. Currently, the most wealthy, as well as the least developed, East European entrants report a larger gap (Hishow, May 2004).

Catching up with the per capita income of the EU-15 will require growth rates at least three percentage points above the long run average of the old members. A weaker record will reflect foregone wealth and standard of living, since one percentage point higher growth cuts the catch-up period by almost 20 years.

Growth is generated by demand expansion, which in turn depends on national, and policy related preconditions in any country. Nations with small savings rates will need to import capital and implement new technology and innovations to accelerate productivity growth as a core precondition to catch-up with the West. Because economic integration entails the removal of barriers to the free flow of goods, capital, labor and services, the future outcome – a convergence of the per capita income – will be to the satisfaction of the entire EU. Evidence suggests that these poor nations would otherwise lag behind for decades, causing frustration with liberalization and stirring an anti-European mood. So the task of EU integration does have a strong convergence underpinning.

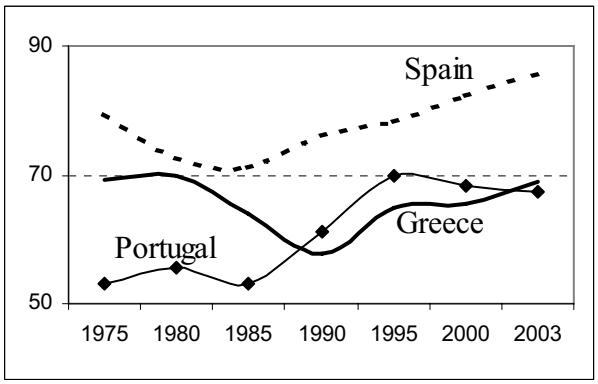
This gives an idea of the critical importance of a common strategy for growth in Europe, as called for in the Lisbon strategy of the EU. Back in March 2000, the EU heads of state and government convened in Lisbon to pursue the strategic objective of turning the Union into "the most competitive and dynamic knowledge-based economy in the world" by 2010. The rationale of the Lisbon idea was to embark on a broad program to stimulate a general process of mutually strengthening reforms in the EU's labor, financial, product-related and service-related markets. Notwithstanding the enthusiasm, soon after the adoption of the Lisbon Strategy real economic

growth started running out of steam. Indeed, the estimated average annual growth of 1.4% in the euro-zone between 2000 and 2005 has been particularly unsatisfactory.

Fortunately, since the mid-nineties the Central and East European (CEE) region as a whole achieved higher growth than the EU-15 countries and is about to overcome its economic backwardness. By raising productivity, the income gap is about to close gradually. But as some core-periphery models suggest (Krugman 1991, Krugman/Venables 1996), the success can reverse and the core (the richer West) may even further expand its lead at the expense of the periphery (the poorer East). Western experience, too, tends to support the view that different income levels and returns to investment between nations alone are no guarantee for catching-up.

Specifically, some of the cohesion economies, foremost Ireland and Spain, achieved remarkable growth which resulted in a per capita GDP above the average (Ireland), or in almost closing the gap (Spain). Nonetheless, Spain's catch-up process has not been straightforward. Rather, after some divergence in the wake of the transition from General Franco's dictatorship to democracy, its economy had succeeded in switching to a more sustained convergence path. Portugal did better until the mid-nineties when the catch-up process flagged under conditions of weak growth. Worse, Greece has not been able to converge in real terms yet (Figure 1).

Figure 1: Per Capita GDP in Cohesion Countries, Percent of EU-15 Average



Source: European Commission, Directorate-General for Economic and Financial Affairs: *European Economy*, Nr.6/2004, Statistical Annex.

As for Eastern Europe, the conclusion is that closing the income gap will not come automatically at the end of the day, i.e., simply as a result of the opening up and integration into the EU-15 economy. If CEE economies stay competitive, capital inflow, growth, and real convergence will continue. But what is competitive? A prerequisite is that market distortions are avoided, so market forces can bring about real per capita convergence of the East toward the EU-15 median

(Sinn/Ochel, 2003). Some authors link the attractiveness of a nation as regards foreign investment to differences in institution-building (Winiecki, 2004). Others argue, however, that even good governance sometimes may not succeed in pulling an economy out of a growth crisis. This may be the case when foreign direct investment (FDI) circumvents a country with a poor infrastructure and weak human capital (Sachs et al., 2004).

While institutions in the accession countries improved significantly, infrastructure is not poor and human capital is strong. Because of the relatively short distances and good road and railroad system in Europe, transport costs seem to be of lesser importance, though in some industries they may prove an obstacle to more ex- and import. Of greater importance is, however, to raise the capital stock per worker, which is -according to IMF capital-stock-to-GDP-ratio estimates- at this stage roughly three times smaller than in the developed world (Doyle et al., 2001). But given limited saving rates of around 20 percent of GDP in the accession countries (in the period 2000 through 2004, partly resulting from persistent government deficits, i.e. negative public saving), capital import from the West is a great opportunity for boosting investment and growth (GKI, 2004). Foreign direct investment contributed up to 5 percentage points to the investment rate in East Central Europe. FDI inflow to CEE region culminated in 2002 at $22.56 billion against $2.23 billion in 1991 (UNECE, 2005). However, as shown above, foreign capital is affecting the economy of poor countries in different way. The most striking examples in the EU-15 are offered by Ireland, with high growth rates and clear convergence on the one hand, and by Greece's economy, which, despite generous structural fund transfers, fell behind the EU average in the eighties, on the other.

Until now the former Central and East European EU members have hardly been recipients of large official transfers and grants. Yet they have performed with respect to their growth rates better than almost any of the incumbent EU member states. Standard datasets comprising output growth, investment, labor supply and foreign direct investment suggest ability on the side of the CEE economies to catch up by opening up, overcoming macroeconomic disequilibria, and, importantly, avoiding "euro-sclerosis". Here the preparedness of the CEE countries to adapt to globally changing economic conditions is crucial, but politically their better performance is a sensitive issue. Against the backdrop of growing euro-skepticism demonstrated by the rejection of the Constitutional Treaty in some old member states, the debate about unfair tax competition by, and job export to, the new members is delicate. After all, between 2001 and 2004 alone, the foreign investment that has entered the CEE area has created among other things between 8 000 and 10 000 jobs in the rapidly expanding automobile and ICT industry there.

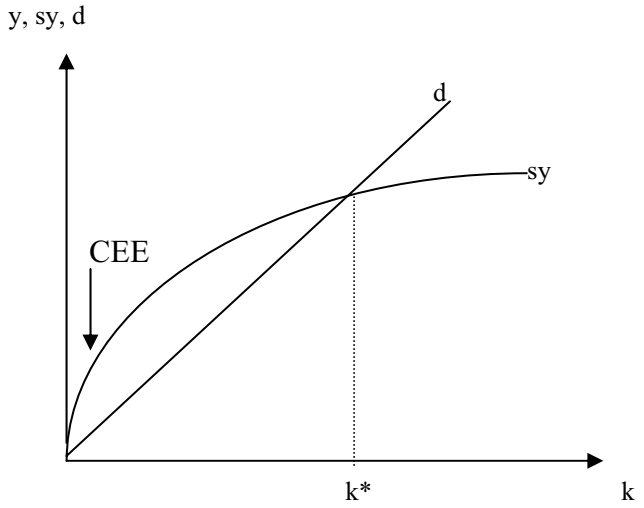
The finding is, anyway, that contrary to the perception of some euroskeptics, the CEE partners are not on the payroll of the old members. Central to the previous/current success of the new member states are other crucial variables, more specifically the materializing on the own specific comparative advantages, and labor productivity. In Poland, Hungary, the Czech Republic and others, whose economy counts for 80 percent of the combined output of the 10 new entrants, GDP growth has been driven predominantly by productivity gains (and, nor surprisingly, by expansion of private consumption). In all new member countries the labor supply index declined from 100 in 1989 to between 74 in Hungary and 88 in the Czech republic in 2002.

While in Poland the unleashing of market forces since 1990 has enabled the economy to improve the capital stock utilization, in Hungary, where a vibrant private sector was established prior to the system change, investment in new capital has been the main driving force for growth. In contrast, a low consumption index of only 113.6 since 1991 barely supported the country's aggregate demand. Here, and to a lesser extent in the Czech Republic, export demand helped while productivity gains associated with cuts in active labor force have strongly contributed to growth. Therefore, integration and permanent adjustment to the changing requirements of the market after the opening-up and the abolition of the trade monopoly of the planning authorities contributed to the success. A strong link between output growth and export as well as import can be observed in Poland, Hungary and Slovenia, and, to a lesser extent, in the Czech and Slovak Republic, too. In addition, private consumption seems to have had a strong impact on growth in the former Czechoslovak Republics and Slovenia (Hishow, July 2004).

The limits of growth and the importance of Lisbon

The discussion surrounding output performance in Central and Eastern Europe after the fall of the Berlin Wall stressed the role of capital accumulation, which is -alongside other determinants- of overwhelming importance to growth. Yet growth theory points out that there is no simple correlation between everlasting investment and continuous growth. Sometimes growth-rate declines dramatically to cause problems like exploding unemployment or unsustainable budget deficits. So, faster growth now is not a guarantee that the new entrants will converge on the EU-15 income level. They may end up only converging towards their individual steady states (?). Conversely, higher levels of saving and investment than in Western Europe can translate into higher standards of living, once they are sustainable and total factor productivity contribution to growth is not insignificant. In short, to catch up, the CEE economies must shift the output schedule upward.

Figure 2: Hypothetical current position of CEE relative to steady state k*



In Figure 2 the output per worker y is a function of capital per worker k, which for his part is a function of the investment in capital stock sy. Yet only net investment, i.e. sy minus depreciation d, is adding new capital. Given a constant investment rate, the bigger the capital stock per worker k the smaller the net change of capital stock. Clearly, at early stages of capital stock build-up any additional rise in capital causes the output to rise strongly. But at higher levels of capital the marginal product of capital is declining. When the investment and depreciation curves intersect, there is no further growth of the capital stock per worker, and consequently, the output growth comes to a halt. If there is no technological progress the economy is in steady state equilibrium, where GDP remains at zero growth.

In the diagram the hypothetical position of the CEE economies is depicted, meaning that CEE is not reaching a (zero growth) steady state yet. But the key conclusion is that, other things equal, the region sooner rather than later will achieve steady state. Then, if CEE reached a steady state at a lower level of capital per worker than the EU-15 there would have been no East-West convergence in real terms, i.e. the income gap would persist. Empirical results too are instructive: The convergence of the CEE economies towards the average of the pre-2004 EU remains fragile because of currently small growth-rate differentials between Western and Eastern Europe. Some of the CEE nations, like the Czech Republic, have even been losing position, whereas others, like Estonia, recovered well from the transition crisis. Hungary, too, succeeded in catching up. Poland performed better in the early nineties as it used to be the growth champion among the European countries in transition, but the country lost luster after its output started to expand only modestly since then.

In Western Europe, the leeway for knowledge-based high-tech growth is not being exploited. For instance, in the 1990s the EU-15 overtook the USA in productivity growth in the low-tech sector, whereas the annual gain in productivity in Europe's ICT sector remained roughly 1.5 percentage points behind that of its American counterpart. Furthermore, in the EU-15 the high-tech sector's share of GDP (33 percent) is smaller than the 38 percent in the US (Sapir, 2004). The reason why Europe is lagging behind in this are is the hesitation displayed in the past in implementing new technologies. Only the Nordic countries find themselves in the leading group here, whereas some major EU economies, especially France, have only put in a mediocre performance in this connection. Another unfavorable fact is that the share of expenditure on ICT in the EU-15 appears to be declining. Consequently, research and development (R&D) are not yet playing the role they were intended to play. One problem is that the Union as a whole invests a lower proportion of its GDP in R&D than the USA and Japan; another is that R&D spending by some major EU economies, like France, is waning, whereas in the United Kingdom it is stagnating, and Germany too is lagging behind the USA and Japan in this respect. Moreover, it is still true today that less corporate research is being conducted in Europe than in the USA, yet it is that very research which determines an economy's ability to innovate, for state-organized R&D tends to be more fundamental and therefore impacts less on growth and modernization than application-oriented research conducted by businesses.

Thus the experience of the old members so far hints at the answer to a question like “Which Economic Policy in CEE, then?” The answer is implicitly given by the central issue of Lisbon, namely making the EU a knowledge-based economy. The latter refers firstly to better exploiting technical progress and innovation, which calls for the improvement of education and vocational training. Secondly, it refers to the better utilization of labor as an important input constituting growth.

Since the prime task of economic policy in a number of CEE new member states is to cope with nasty and even rising unemployment rates, it is reasonable to look at the labor input over time. A crucial question related to growth and employment is therefore how vigorously the East Europeans utilize the available labor potential to achieve high employment ratios and to avoid foregone national income. If, for instance, a nation is suffering high labor costs, enforcing arbitrary minimum wages, or is over-regulating the labor market, then companies in this country will try to rely heavily on capital input (and technological progress) instead of creating jobs. The unemployment rate will rise, causing losses of national income and slowing the economy.[i] Obviously, nations like Poland, Slovakia, Latvia, and others in the EU need to reduce

significantly their unemployment rates which currently lie between 18 and 10 percent of the labor force.

As pointed out, the economies of the accession countries and in particular those of Central and Eastern Europe are growing faster than the average of the EU-15, because the effective stock of capital of each employee is relatively small. This is so because their stock-of-capital-to-GNP ratio lies between 2.5 and 3, while their output per capita is scarcely half as great as that of the Western part of the Union. Since their national economies work with relatively little capital, the marginal product of capital, and therefore the rate of growth of the economy, is relatively large (see Figure 2). The high marginal productivity of capital has, however, led to the switch made by numerous CEE economies to a capital-based economy. Investment quotas of up to 34% in Slovakia, and 33% in the Czech Republic and Estonia are comparable to the levels in the so-called "Asian Tiger States".

Since the CEE countries have sped up their growth through the stimulation of investment, so long as investment quotas are raised there will be a higher rate of growth. Yet the rate of growth sinks after a certain time because of the sinking capital yield. Thus the capital stock, investment quotas and level of consumption of the national economies of the accession countries may stay far from the optimum. In an optimum situation, the consumption quota of the economy is maximized at a given investment quota, which means that the stock of capital performs the "Golden Rule Level of Capital". In other words, every economy can reach an optimal position as regards the maximization of consumption at a given investment quota (about the algebra of the Golden rule see Hishow, 2005).

A general test of the Golden Rule in the accession countries shows that they all function with suboptimal levels of capital (Table 1).

Table 1: Macroeconomic indicators and the fulfillment of the Golden Rule of Capital, per cent 1993-2005

	Cz	Hu	Pl	Slk	Slv	Est	Lat	Lit	Cy	Mlt
GDP growth g	2.7	4.1	3.9	4.2	3.8	5.2	4.4	2.9	3.5	3.1
Marginal product of capital MPK	11	13	13	12	12	13	14	14	12	12

Depreciation of capital δ	5	6	6	5	6	6	6	6	5	5
Golden Rule: MPK-δ-g = 0	3.2 (not fulfilled)	3.4 (not fulfilled)	3.0 (not fulfilled)	2.4 (not fulfilled)	2.6 (not fulfilled)	2.9 (not fulfilled)	3.9 (not fulfilled)	5.9 (not fulfilled)	3.2 (not fulfilled)	3.5 (not fulfilled)

2005 Estimate. Sources: IMF; EU Commission; own calculations

It can be inferred from the last lines of Table 1 that some accession economies- namely Slovakia and Slovenia - are quite close to the point of the Golden Rule, whilst others – namely Lithuania- are far from it. Thus the individual national economies operate with differing degrees of efficiency. Some are closer than others to the optimal capital stock. In order to explain the divergent growth dynamics, the employment development and the rate of technological progress, in particular the total factor productivity (TFP) growth, come into consideration.

Consideration of developments in employment is important because all CEE countries have shown a growing capital intensity (capital per employee) and labor productivity (GDP per employee) since 1993. With the exceptions of Hungary and Slovenia, they have cut jobs massively and reduced employment, or have not been able to compensate the loss of jobs since the early 1990s. From the perspective of the national economy and according to formulae, productivity gains are not enough to ensure wealth development (expressed as growth of output per capita): growth in employment is also important. In growth accounting, labor growth carries twice as much weight as growth in capital, so that countries with a positive employment development will, amongst other things, enjoy a greater GDP growth than countries with a stagnating or sinking level of employment. Since the beginning of the 1990s, that included Hungary and Slovenia in CEE, and - in the old market economies - Cyprus and Malta. In these countries, the economic growth constituted by productivity and employment growth increased, and the unemployment rates remained under control.

Table 2: Year on year growth rates 1993-2005 by country, per cent

	Labor productivity	Capital per worker	Employment	GDP
Cz	2.86	5.63	-0.12	2.74
Hu	3.45	5.87	0.69	4.14

Pl	4.50	8.23	-0.60	3.90
Slk	4.32	4.03	-0.04	4.28
Slv	3.49	8.98	0.30	3.79
Est	6.67	9.92	-1.44	5.23
Lat	6.02	17.36	-1.59	4.44
Lit	3.66	11.85	-0.77	2.89
Cy	2.15	1.89	1.33	3.48
Mlt	2.35	0.58	0.75	3.10

2005 estimate; Source: EU Commission. DG EcFin. European Economy. No 6/2004. Tab. 91 ff.

The experience of the Western European catch-up economies, in particular of Spain, shows that growth correlates more strongly with the dynamic of labor growth than capital growth. Spanish growth was, over a long term, labor-intensive: employment has risen with a yearly average of almost 2 percent since 1986. This was for this country, with its massive latent unemployment under General Franco and its high - sometimes more than 18% - official unemployment rates in the 1980s and 1990s, a successful strategy.

This compares to the economic developments in those continental countries which are lagging behind when it comes to reform- Germany, Italy and France. Between the mid-1970s and the mid-1990s, the unemployment rate doubled in Italy and tripled in France. In Germany, even before 1990, and thus without the effect of reunification, the unemployment rate doubled, and this trend continued post-1990. The related effect upon GDP growth-rates was unfavorable.

It is theoretically possible that national economies can grow even without the growth of physical input-factors (in the rule physical capital and labor). It suffices for an economy to remain innovative; the overall rate of growth is dependent upon the growth rate of technological progress (of the TFP). Similarly, there can be situations where the economy grows without a contribution from technology - simply because of a growth of capital per worker. The accession countries offer examples of the most divergent variants. In the Czech Republic and Cyprus. the rate of technological progress - both labor augmenting (LATP) and TFP - was relatively restrained. Estonia and Slovakia show a high level of dynamism. whilst Latvia and Lithuania report only negligible or negative growth in technological progress. Since these countries

struggled with declining employment at rates of -1.59 and -0.77 respectively between 1993 and 2005, economic growth was exclusively capital-based. Conversely, in Hungary. Slovenia, Malta and Cyprus it was rather more balanced, because it occurred with the growth of all factors – labor, technology, and physical capital.

Table 3: Year on year growth rates 1993-2005 by country, per cent

	Cz	Hu	Pl	Slk	Slv	Est	Lat	Lit	Cy	Mlt
Capital stock	5.51	6.56	7.63	3.99	9.28	8.48	15.77	11.08	3.22	1.33
Labor augmenting technical progress	1.5	2.26	2.66	4.47	1.14	5.14	-0.08	-0.95	2.42	3.8
Total Factor Productivity	1.01	1.51	1.78	2.9	0.8	3.49	0	-0.61	1.21	2.09

2005 estimate; Source: EU Commission. DG EcFin. European Economy. No 6/2004. Tab. 91 ff.

With regard to such trends, the goal of creating a dynamic knowledge-based economy in Europe, as contained in the EU's Lisbon Strategy is vital for the future of the Union. Slow-growing economies would thereby enjoy tangible growth effects thanks to new processes of production and organization, including a growing level of qualification. Because of the lagging TFP growth, the Lisbon goal of investing 3% of GNP on innovation, technology and education, as well as in research and development, would have to be raised. In the medium term, even with a rise in the level of R&D spending from the current 1.9% to the existing Lisbon goal of 3%, the growth effect would remain restrained. The reason for this lies in the low rate of TFP growth in the large continental European economies, so that more -even a third more - R&D investment would accelerate GNP growth at best relatively weakly. In the US the values are more favorable, so that European efforts must be wide-ranging if the goal of creating a knowledge-based economy in a foreseeable time-frame is to be achieved.

Since knowledge is dependent upon human capital, the previous/ current trend of capital based growth in the CEE area - especially against the backdrop of the EU-15 experience - is to be critically judged. In the EU-15, at least the large economies rely on a growth strategy without any credible labor input. Because of the negligible effect of capital input, their growth rates - even before the opening up of Eastern Europe and China's rise as an export power - were small. A more energetic implementation of technical breakthroughs and innovations would have accelerated these economies. Continental Western European economies would have grown a quarter faster (at 2.7%), if the growth rate of technical progress were as great as in the US

(1.5%), This would have entailed a positive effect upon the labor market.

Conclusions

After the latest enlargement in 2004, the EU has nominally become the world's largest economic bloc; it had already tied itself to the goal of becoming the world's most dynamic economy. In order to realize this (Lisbon) goal which was formulated at the EU level, the accession countries must now also pull their weight.

Overall analytical findings appear to support a demand-side growth hypothesis in the new market economies of East Central Europe. Here an intensive structural adjustment had freed market forces to better utilize factors of production and to respond properly to previously suppressed household demand. Integration into the European economy is reflected in rising ex- and import indices, which in real terms expanded much faster than real GDP. Because of their economic heterogeneity, the new member sates are facing different economic challenges, Some countries - Hungary, Cyprus and Malta - primarily need to maintain their economic and employment growth. They can draw inspiration from the reform policies of those other countries which suffer from light unemployment.

Latvia, Lithuania, Slovenia and, to a degree, Poland should expand their stock of capital more slowly than before because of their sinking capital productivity. CEE growth must be complementary to the Lisbon Strategy by becoming more technology intensive. In a comparison of the EU and OECD countries, the growth-rate of technological progress in many new member states is either small (Czech Republic, Slovenia, Latvia) or even negative (Lithuania). Only a tangible rise of public and private investment in new technology and innovative processes would help raise the TFP/LATP- growth-rate. If they are to reduce their currently very high unemployment levels, Poland, Slovakia and the Baltics must reshape their model of growth: It must become more labor-based (as opposed to capital-based). Labor-intensive growth occurs in modern national economies in the services, rather than the agricultural, sector.

In order to realize their relative cost advantages in the services sector, the new member states need a free common services market. This is where the EU comes in; under German and French pressure in particular, the free movement of workers and services has not yet been realized. Precisely in the area of labor market policy, a uniform European model despite numerous invocations is not in view. The countries are too heterogeneous and pursue divergent strategies, Without the internal market, the new member states are disadvantaged in terms of their trade and

capital balance, since they are overshadowed by the EU-15 as providers of industrial export goods. The debate about the minimum wage, which is often very ideological in nature, is counterproductive: the Eastern enlargement has created a (temporary) excess supply of labor in the EU, which requires more efficient allocation in across all member countries.

In future, fortunately, labor demand in Eastern Europe may pick up: Recent studies on the effect of the EU enlargement come to the conclusion that the overall effect will be distributed asymmetrically in favor of the CEE entrants, with higher GDP and job gains over time and faster rising income per capita (Bchir/Fontagné/Zanghieri, 2003). This is consistent with the finding that countries in a common economic space (common market, customs union, free trade area) tend to specialize on specific products and thus economic integration is associated with divergence in their sectoral structures (Midelfart/Overman/Venables, 2003). Hence specialization is boosting productivity and is facilitating the catch-up process in the low income region/country (in this case CEE).

The EU Commission can make itself useful insofar as it can audibly insert itself in national reform debates and clearly draw attention to the economic costs, which could arise from a new protectionism and redistributive EU-economic model. The Commission should also make clear that, in an increasingly integrated EU economy, in which the new member sates participate, "the right of the strong" cannot win out. Even large national economies cannot exist as an autarchy without any exchange with the rest of the Union. If a country tried to isolate itself from this process of economic enmeshment, which is driven by costs and productivity, it would incur a loss of position in the technological sector. This would run contrary to the core Lisbon idea of sidelining unemployment through knowledge-based growth.

References

A. Avdoulos, Ph. Derveaux, Cyclical Adjustment of Budget Balances, in: European Commission, Directorate General Ecfin, Ecfin/Rep/50885/2005, p. 9

Baldwin, Richard E. & Martin, Philippe, Agglomeration and Regional Growth. *CEPR Discussion Paper No, 3960*, http://ssrn,com/abstract=436996 (July 2003)

Barro, R. J., The Interplay between Economic and Political Development, in

'Determinants of Economic Growth', Cambridge: MIT Press, 1997, pp. 49-87

Barry, F., Economic Integration and Convergence Process in the EU Cohesion Countries. *Journal of Common Market Studies*, 41, 5 2003, pp. 897-922

Bchir, H., Fontagné, L., Zanghieri, P., The Impact of EU Enlargement on Member States: a CGE Approach. *CEPII Working Paper No 2003-10*, August 2003

Doyle, P., Kuijs, L., Jiang, G., Real Convergence to EU Income Levels: Central Europe from 1990 to the Long Term. *IMF Working Paper 01/146*, September 2001, IMF, Washington, DC

EU Commission, European Economy, No 6/2004, Statistical Annex, Brussels, 2005

Geppert, K., Goring, M., Stephan, A.., 'Productivity Differences in the EU: National, Regional and Spatial Effects', German Institute for Economic Research Berlin, DIW-*Diskussionspapiere*, No 383, November, 2003

GKI Economic Research Co, Direct Investment Flows in CEE, in: Economic Trends and Research Summaries 2004, No 4, Budapest 2004

Haynes, M.J., Husan, R, Somewhere Over the Rainbow: The Post-Soviet Transition, the Market and the Mythical Process of Convergence. *Post-Communist Economies*,14, 3/2002, pp. 381-398
Hishow, O.N., 'EU Extension to the East and Exporting Jobs, Tax harmonization may hurt more and benefit less', *SWP Comments* 2004/08, May 2004

Hishow, O.N., 'Economic Effects of EU Eastern Expansion, High Growth in the New Member Economies with a Continuing Prosperity Gap. *SWP Research paper* 2004/S 26, July 2004

Hishow, O.N., Wachstumsfaktoren in den Beitrittsökonomien: Kann die Lissabon-Strategie umgesetzt werden? Osteuropa-Wirtschaft, 50, June 2005, pp.96 - 110

Hospers, G. J., 'Beyond the Blue Banana? Structural Change in Europe's Geo-Economy', *Intereconomics*, Hamburg Institute of International Economics (HWWA), Vol, 38, No 2, March/April 2003, pp. 76-85

Kaitila, V., 'Convergence of Real GDP per Capita in the EU 15, How Do the Accession Countries Fit in?', ENEPRI, *Working Paper No, 25/January 2004*, http://www.enepri.org

Krugman, P., 'Increasing Returns and Economic Geography', *Journal of Political Economy*, Vol. 99, No 3, June 1991

Krugman, P., Venables, A.J., 'Integration, Specialization, and Adjustment', *European Economic Review*, Vol. 40, 1996, pp, 959-967

Miderfart, K,-H., Overman, H,G., Venables, A.J., 'Monetary Union and the Economic Geography of Europe', *Journal of Common Market Studies*, Vol. 41, No 5, December 2003, pp. 847-868

Nunnenkamp, P., Wachstumseffekte von Direktinvestitionen in Entwicklungsländern (Growth Effects of Direct Investment in Developing Countries). *Die Weltwirtschaft*, No 1/2004, Institute of World Economics, Kiel, pp. 99-118

Sachs, J. D., McArthur, J., Schmidt-Traub, G., Kruk, M., Bahadur, Ch., Faye, M., McCord, G., 'Ending Africa's Poverty Trap', *Brookings Papers on Economic Acriticvity*, 1, 2004, pp. 117-240

Sapir, A., et al., An Agenda for a Growing Europe, Making the EU Economic System Deliver, Oxford 2004

Sinn, H,W., Ochel, W., Social Union, Convergence and Migration. Journal of Common Market Studies, 41, 5, 2003, pp. 869-896

Winiecki, J., Determinants of Catching Up or Falling Behind: Interaction of Formal and Informal Institutions. *Post-Communist Economies*, 16, 2, 2004, pp. 137-152

UNECE, Economic Survey of Europe, 2005 No 1, *Statistical Appendix*

According to Okun's law, one extra point of unemployment over the natural rate of unemployment costs 2 percentage points of output.